

## *The effect of practicing professional skepticism on the quality of auditor's performance*

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### **Abstract**

*This research aims mainly to determine the impact of the existence of an impact between the components of the audit risk and the quality of the audit, and the research began with a major problem that included several questions revolving around the nature of the affective relationships between the variables in the field, although international auditing standards oblige the auditor to design the audit process in a way that ensures reasonable assurances about the discovery of material errors, in order to reduce the audit risks that surround the institution under audit, and the components of audit risks can be expressed in (detection risks, risks control, acceptable audit risks and inherent or inherent risks), Which represents the audit risk model that reveals to the auditor the various risks that he is willing to bear and has adopted the descriptive analytical approach as a basic approach in the research, the audits were studied in one of the audit companies approved by the Markets and Securities Commission in Iraq. Audit data was used from audits conducted over a specified period of time, from 2018 to 2019. The audits of 25 clients spread across six different sectors were studied. The research aims to analyze financial statements, audited reports and audit risk levels, maintaining the confidentiality of the company name, the names of the customers included in the study and the data used in the company's working papers. Through the research, many conclusions were reached, the most important of which was that the use of financial indicators and the focus on the quality of auditing contribute to enhancing the effectiveness of the auditor's opinion and improving the continuity of audited clients. The company's high audit quality level also reflects its dedication to providing professional and reliable services to its clients. The research came out with a set of recommendations, the most important of which is the need for the Securities and Financial Markets Commission in Iraq to pay serious attention to the quality of audits and link them to the risks facing financial reports.*

**Keywords:** *rofessional skepticism, auditor's performance, audit risk .*

## **Introduction**

The audit industry has come under increasing pressure in recent decades to achieve higher quality to reduce the risk to the financial community of making decisions based on misleading data. Persons affected by these misleading statements tend to hold auditors accountable for the damages they suffer due to these decisions. In fact, the auditor's fear of the legal risks and risks associated with trials encourages the profession to adopt the risk approach in the practice of professional auditing.

Although the profession has paid great attention to quality and addressed it through the application of professional standards for auditing, and despite the sometimes focus on obtaining the elements of a good audit through the size of the office and reliance on professional culture and experience, challenges remain. The audit risks faced by the auditor in the exercise of his work require more comprehensive procedures to reach a higher quality that protects and preserves the auditor's reputation from legal risks. This makes testing the impact of an auditor's assessment of audit risk on audit quality important, and this is what the current study is doing.

## **Literature Review**

Organizations are witnessing rapid changes and developments that cast a shadow on their success, survival and continuity, in performing their duties and tasks required in an accelerated environment characterized by continuous change, as it imposes on them a set of challenges that require them to invest their strategies and employ them in a way that makes them able to renew and revive their resources compatible with their strategies in a way that ensures achieving alignment with their environment, responding quickly to their requirements, and working to ensure that their outputs are compatible with the actual needs of society. All

organizations operate in a dynamic, highly complex environment, which has to adapt to work within ever-changing administrative, economic, technological and societal frameworks.

The problem of the study lies in determining the presence of an effect between the components of audit risk and the quality of the audit. Risk is the main factor in all financial decisions, and the audit, whose decision is represented in the auditor's opinion regarding the extent of disclosure in the financial statements, must depend on audit risk factors like other strategic financial decisions, without being satisfied with descriptive studies that focus on the definition of quality, its factors, inputs and outputs and other standards that dealt with quality. This study seeks to understand the impact that audit risk assessment can have on audit quality in Iraq, with the aim of improving the efficiency and effectiveness of audits. The study aims to explore and evaluate the relationship between auditors' assessment of audit risk and various aspects of audit quality, including inherent risk, material misstatements resulting from fraud, risk of control, risk of planned discovery, and material misstatements resulting from error and fraud.

The study is of great importance as it is directly related between audit risks and audit quality, and this is the focus of attention of the parties benefiting from audit services. This vital link fosters a sense of comfort and confidence for decision-makers, allowing them to rely on reliable audit services to make critical decisions.

The study will test and test the impact of audit risk assessment on the quality of audits conducted in Iraq. The research aims to benefit from the results of these tests to enhance the accounting profession in Iraq in general, and to enhance the quality of services of audit companies and offices in Iraq in particular.

To complement the requirements of the research and in order to answer the questions raised by the researcher in the research problem and test its hypothetical scheme, the research adopted a set of hypotheses to answer these questions as follows:

There is a significant correlation between audit risk and audit quality at the significance level of 0.05 and the following sub-hypotheses emerge from it:

1. There is a significant correlation between the auditor's assessment of the audit risks inherent in the quality of the audit.
2. There is a significant correlation between the assessment of

The risk is defined in the context of an audit as the possibility of a loss or decline in profit or lead, which differs from the expected expectations of the outcome of a decision or activity (Inventory, 2014, p. 28). Risk can also be defined as the possibility of a bad outcome, loss or other undesirable occurrence due to uncertainty (Arar, 2009, p. 17).

It should be noted that the concept of risk is not new in the field of audit or to the auditors responsible for taking the appropriate audit actions, which constitute the audit program. This concept has been referred to in the auditing standards since the last century (Alderman et al., 1989, p. 55). In 1983, the American Association of Auditing Accountants (AICPA) provided a definition of audit risk in its statement No. 47 entitled "Audit Risk and Materiality in the Audit Process", describing it as "the risk of the auditor failing to give a valid opinion on materially distorted financial statements, without his knowledge of such misstatement", and this definition is identical to the International Federation of Auditing Accountants' (IAASB) definition of audit risk, as it is contained in IAS 400 of 1991 and also in IAS 200 of 2014, which Risk auditing is defined

as For its part, the International Federation of Accountants for Auditing (IFAC) considered that audit risk does not include the auditor's view of material misstatements in the financial statements when there are no material misstatements. These risks also do not include the auditor's business risks such as legal losses, adverse publicity losses or other events that may arise in the audit of financial statements (IAASB, 2014, p. 91).

Peter, 2019 described audit risk as the risk of the auditor not providing an appropriate opinion on the financial statements as a result of incorrect conclusions during the audit process, and therefore the auditor's incorrect opinion towards those statements (Peter, 2019). Peter added that audit risk can be expressed as the risk of an auditor's failure to make the necessary adjustment to his opinion on financial statements that contain material misstatements (Peter, 2011). International Standards on Auditing indicate that the auditor is unable to fully reduce the audit risk and therefore cannot obtain absolute assurance that the financial statements are free of material misstatement, due to implicit limitations to the audit process, which leads to providing most of the evidence that the auditor relies on in reaching his conclusions. The concept of quality is one of the modern concepts that appeared in the last quarter of the twentieth century, and its concept changed after the development of management science, the emergence of large companies, and increased competition. Quality is defined as the set of qualities and characteristics that characterize a product or service and lead to meeting the needs of consumers and customers. Quality aims at product design, manufacturing, and performance in a way that satisfies and pleases consumers (Nkeh and Al-Asadi, 2013, p. 264). Quality is also defined in the Oxford Dictionary as the high degree of quality or value.

With the development of economic life, the European Community has developed a quality standard, ISO (International Standardization Organization). This standard focuses on requiring organizations to follow procedures within systematic quality management. The International Organization for Standardization sets global standards for the quality management system in organizations, whether productive or service. Despite the importance of the concept of audit quality, a comprehensive and clear definition of it has not been standardized. This is due to the presence of multiple and different views towards it. Despite this diversity, two main schools can be distinguished in the definition of knock quality.

First School: DeAngelo's definition of audit quality:

De Angelo's (1981, p. 186) definition of audit quality is one of the most widely accepted definitions in the field of auditing. Audit quality was defined as the probability of the auditor detecting and reporting any breach in the client's accounting system. De Angelo won in his definition that independence is the factor that increases the likelihood that an auditor will report errors. According to De Angelo's definition, audit quality means an increased auditor's ability to detect misinformation in financial statements through the power of independence. Quality has been divided into two parts: the first relates to the auditor's eligibility and the second concerns the objectivity of the auditor and his conduct with respect to misleading in the financial statements.

However, the definition did not specify precisely how audit quality would be measured, whether from a stakeholder point of view or through audit inputs or outputs. It is also not specified whether quality should be measured during the engagement phase or after the end of the investigation, and whether it is related to the quality

of the client or to the information being audited. Although it is the most widely used definition in the field of audit quality, it is not defined in detail, as well as Based on this definition, audit quality can be measured indirectly through key indicators. Studies indicate that statistical estimates of estimated accruals in financial statements are one of the most commonly used agents to measure audit quality. It is assumed that company representatives are trying to manage annual results to maximize benefit, so the quality of the audit in this context means that the auditor is able to prevent estimated accruals in the financial statements. There are also other agents for audit quality as defined by DeAngelo, such as continuity reports that can be used as an indicator of audit quality in applied studies.

Indeed, DeAngelo's definition correlates audit quality with financial reporting quality. A financial report represents high audit quality when the auditor performs actions to prevent error and presents them in his report. DiAngelo considers the level of assurance that there are no material errors undetected and not presented in the auditor's report to be a measure of audit quality.

### Second School: Level of Compliance with Standards

The orientation of this school indicates that the auditor achieves high quality if his work is fully matched to the relevant standards. The level of compliance with audit standards is an indicator of the level of audit quality. The results of peer audits, inspection results of oversight boards such as PCAOB in the United States, and lawsuits against auditors are the best indicators of the level of audit quality available.

Among the adherents of this school, Copley et al., 1993, Krishnan et al., Wiemann, 2011, McConnell et al., 1998, Aldhizer et al., 1999, and Niemann, 2004 can be mentioned. However, Krishnan

and his colleagues criticized this school, noting that the overall goal of the audit process is not to strictly comply with the relevant standards, but rather to ensure access to high quality financial reporting. This view was endorsed by the European Commission in 2010 through the Committee on Audit Policy Development at European Level.

### **Measurement of the dependent variable audit quality AQ:**

In his study, the researcher relied on the use of a model to measure the quality of auditing based on previous studies and research that dealt with the subject of audit quality. This model was used to assess the quality level of audit in a study shop company. Audit risk estimation data were obtained at the analyst company to study the relationship between audit risk and the audit quality index.

Accordingly, the researcher used multiple logistic regression test to analyze the data and study the relationship between the variables. The auditor's opinion on the continuity of the audited client was used as an indicator (agent) of audit quality, and was linked to the ZFC Scale. This model was determined to measure audit quality based on previous studies on this topic mentioned in the first and second semesters of the study, such as (2011, Francis) and (2010, Saleh).

### **Audit Quality Measurement**

The audit quality indicator "Continuity of the audited customer" is used in the regression equation by the following values:

1. Value (0): Indicates the auditor's correct opinion on the continuity or non-continuity of the client under audit. It means that the auditor has provided a correct report that correctly reflects the client's continuity status.



2. Value (1): Indicates that the auditor has made a type 1 error, when the auditor incorrectly indicates in his report that the client under audit cannot continue. It means that the auditor has submitted a report stating that the client is not going on wrong.

3. Value (2): Indicates that the auditor has made a type 2 error, when the auditor incorrectly indicates in his report the possibility of continuing the client subject to audit. It means that the auditor has wrongly submitted a report stating continuity.

### **ZFC Measurement Zemoseki Scale:**

The weighting-based model for a set of financial ratios is based on expectations of financial default. Zmijewski included three financial ratios in his model using financial reporting for a group of companies from 1972 to 1978. These financial ratios are:

1. Return on Total Assets (ROA): It is calculated by dividing the net profit by the average total assets. It helps measure the efficiency of using assets to make profits.

2. Leverage Ratio (LEV): calculated by dividing total liabilities by total assets. It helps assess the extent to which a company uses debt financing relative to its working size.

3. Liquidity: It is calculated by dividing current assets by current liabilities. Reflects the ability to meet outstanding liabilities in the near term.

Through probit analysis, which is based on the aggregate function of the normal distribution, the probability of financial default is measured. The value of the function ranges between zero and one, where the closer the value to one, the greater the probability of financial default, and vice versa, the closer the value to zero, the less likely it is to default (Saleh, 2010, p. 462).

The researcher believes that it is necessary to include the Zemosiki scale to measure financial default in the regression equation. This measure will be examined in the following section to confirm or deny the validity of the auditor's opinion on the continuity of the client subject to audit.

Looking at the available data, the average Zemosky score for all the companies studied is 0.146. The lowest value ranges from approximately 0.000001, suggesting that the company is far from financial distress. The highest value was 0.899, which is above 0.5 and close to one, indicating that there is a high probability of the company's financial default. In the following table, some descriptive statistics and the distribution of companies according to their scores on the Zemoski scale are presented.

**Table 1 Descriptive statistics of the Zemosky scale**

	Standard deviation	Average	Upper limit	The bare minimum	Sample size*2
Zemosky scale	0.25	0.165	0.899	0.00001	2*25

The table shows that most companies scored low relative to the Zemoski scale, indicating their distance from financial distress. , it turns out that the companies studied scored low on the Zemoski scale. In this context, it is assumed that the Zemosky scale is used to assess the level of financial distress of companies.

When a company scores low on the Zemoski scale, it indicates that it is far from financially distressing. Accordingly, companies with low scores on the scale can be considered more financially stable,

and have the ability to meet their financial obligations and achieve sustainable growth.

The following table shows the distribution of Zemosky scale values for the fifty audits:

**Table 2 Percentage of financially distressed customers according to the Zemoski scale**

Percentage	There is a financial distress	Number of customers corresponding to	Zemosky scale
%84	No	21	Less than 0.5
%16	Yes	4	0.5 or more

It was found that there were eight companies that had Zemosky scores above 0.50 (i.e. above 50%), suggesting a potential for financial default in those companies. In contrast, the remaining 21 companies had Zemoski scores below 0.50, suggesting they are far from financial distress. According to this information, eight companies with Zemosky scores were found to have exceeded the value of 0.50, indicating the possibility of financial distress in those companies. This means that there are financial risks that these companies may face and may need additional attention to ensure their financial stability and ability to meet their financial obligations. On the other hand, the remaining 21 companies had Zemosky scores below 0.50, Which means that it distances itself from financial distress. In light of this, these companies are considered more financially stable and have the ability to deal well

with financial challenges and maintain the sustainability of their business.

It is clear from scores above 0.50 that this criterion is an important barrier to identifying companies that may face financial difficulties. It is essential to carefully monitor these eight companies to assess potential risks and take measures to address any potential financial challenges in the future.

However, it should be taken into account that the interpretation of scores and conclusions related to financial distress must be based on specific criteria for the Zemoski scale, as well as other factors affecting the general financial position of the companies studied. In the same context, Table (4) shows the results of the comparison between the findings of the Zemoski scale and the auditor's opinion on the continuity of the audited company:

**Table 3 Distribution of the auditor's opinion on the continuity of the client under audit based on the Zemoski scale.**

prototype	ZFC model due to no financial default	ZFC model due to financial distress
Auditor's Decision	Type I error	Correct decision
Auditor's Opinion Indicates Unviability	0%	0%

The study found that 84% of study clients achieved audit quality, indicating that 42 out of 50 audits were confirmed as correct. This means that these audited firms have confirmed the stability and reliability of the studied companies and supported Zemosky's model with no financial distress. This result enhances the

credibility of the audited company and reflects the quality of its work in providing reliable and accurate financial reports.

The impact of the ZFC scale on audit quality will be studied by analyzing the Spearman correlation coefficient between the scale and the audit quality. This analysis aims to determine the extent of the relationship between the two variables and achieve the statistical significance of the correlation between them. Table 8 can be used to illustrate the value of the Spearman correlation coefficient and the extent to which the statistical significance of this correlation is achieved.

Spearman's correlation analysis requires examining the relationship between the scale and the quality of the audit and evaluating the impact of the scale on the results. If the correlation coefficient value is close to 1 and statistically significant is achieved, this indicates a strong relationship between the metric and the quality of the audit. If statistically significant is achieved, this reinforces the hypothesis that the ZFC scale affects audit quality.

However, the results must be considered and analyzed carefully and professionally, as there may be other factors that affect the quality of the audit regardless of the scale used. So, J

We need to conduct more research and analysis to better understand the relationship between ZFC and audit quality.

The results indicate a negative relationship of moderate intensity between the Zemosky scale and the quality of the audit, with a correlation coefficient of -0.635. This means that an increase in the values of the Zemosky scale is associated with a decrease in the quality of the audit and an increased likelihood of an error in the audit process.

Confirming the statistical significance of this correlation at the significance level of 0.05 enhances the strength of the conclusion and gives confidence in this relationship. Accordingly, it can be argued that the higher the values of the Zemoski scale, and therefore the greater the likelihood of financial default for the audited client, the lower the quality of the audit and the greater the likelihood of an error in the audit process.

Based on the results, several important conclusions were reached. First, the Coefficient of Determination (Cox & Snell R Square) value for the model was 0.558, which means that a model with the independent variable of the Zemosky scale score plus the constant explains about 55.8% of the variation in audit quality. Statistically, the model was statistically significant, with a value of less than 0.05.

In addition, we can look at the value of the constant B associated with the independent variable, and we found that its value is -14.89, and it was statistically significant at the significance level of 0.05. Thus, it can be concluded that the score recorded according to the Zemosky scale plays an important role in influencing the quality of the audit, and the relationship indicates a reverse trend.

Based on this, we can conclude that the score scored according to the Zemosky scale has a fundamental impact on the quality of the audit. The higher this score, the greater the likelihood of error by the auditor, and therefore the lower the quality of the audit. In other words, the quality of the audit decreases by increasing the likelihood of financial default for the audited client.

It is worth noting that we used the Zemosky scale to verify the correctness of the auditor's opinion on the continuity of the audited client. We observed that the auditor made a type II error in four companies over a two-year period each, where the Zemoski scale

indicated financial default. For the rest of the companies surveyed, the measure did not indicate financial distress, and the auditor's opinion turned out to be correct for the remaining 21 companies over 2018 and 2019.

## **Conclusions**

Based on the applied study and hypothesis testing, the results can be summarized as follows:

- 1- The impact of the auditor's assessment of audit risks on the quality of auditing in Iraq is of material and positive importance. This is in line with the trends of the literature on auditing and professional standards in this regard.
2. The risk of disclosure and the risk of material misrepresentations resulting from fraud positively and materially affect the quality of the audit. The impact of these risks was found to be more direct than other components of the audit risk.
3. There is no material impact of the auditor's assessment of the lieutenant risk, the risk of control, the risk of material misstatements resulting from error, fraud and the risk of acceptable audit on the quality of the audit. However, these risks have a relatively weak positive effect.
- 4- The results show that the audit firm's estimates of risk levels changed slightly between 2018 and 2019. It is noticeable that the risk of lieutenant and the risk of material misrepresentations of error and fraud decreased slightly in 2019 compared to 2018. The levels of risk of detection and risk of acceptable scrutiny remained completely unchanged.
5. There is no difference in the estimated risk levels based on the sector to which the customer belongs, except for some differences in the risk of material misrepresentations of fraud, risk of disclosure

and acceptable risk of auditing. The banking and insurance sector had higher levels of risk of material misrepresentations of fraud, while the real estate sector had an acceptable audit risk and the services sector had a risk of detection.

6- The results of the study show that the use of the auditor's opinion as an indicator of the continuity of the client under audit is feasible and effective in measuring the quality of the audit.

7- The results of the study indicate the importance of using some financial indicators, such as the Zemoseki Financial Default Scale (CZF), in measuring the effectiveness of the auditor's opinion on the continuity of the client under audit. This enhances the role of financial indicators in improving audit quality and assessing customer continuity.

8- It was found that the level of audit quality in the study company was relatively high, as the level of quality of audits during 2018 and 2019 was about 84%. This is a good indicator that reflects the company's interest in improving the quality of its work and adhering to international auditing standards.

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